No. 4358

United States
Circuit Court of Appeals
For the Ninth Circuit

In the Matter of SUN DRUG COMPANY, BANKRUPT

R. L. SABIN, as Trustee in Bankruptcy of the SUN DRUG COMPANY,

Petitioner,

vs.

ACME INVESTMENT COMPANY, a Corporation,

Respondent.

Brief for Petitioner

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STATEMENT OF FACTS

On the 15th of February, 1923, the Sun Drug Company entered into a lease, as lessee, with the Acme Investment Company, as lessor, of a building in Portland, Oregon, to be used as a drugstore. (Transcript, pp. 24-31.) Thereupon, the Sun Drug Company proceeded to occupy the building and undertook the due performance of the covenants of the lease. On July 28, 1923, the Acme Investment Company, lessor, notified the Sun Drug Company, lessee,

on account of an alleged breach of covenants, to vacate the premises on or before August 1, 1923. (Transcript, p. 23.)

Shortly thereafter the Sun Drug Company filed its petition in bankruptcy and was adjudicated bankrupt. A Receiver was appointed, and in due time a Trustee was elected—namely, the Petitioner herein. The Trustee occupied the leased premises until the stock of drugs could be inventoried and disposed of. Thereafter the Acme Investment Company filed a claim against the estate in bankruptcy for the occupancy of the premises by the Trustee, and petitioned the Court for its payment. (Transcript, pp. 36 and 37.) The Trustee thereupon objected to the payment of the claim asserted, for the reason that under the lease in question between the Acme Investment Company and the Sun Drug Company, the Sun Drug Company had, upon executing the lease, turned over to the Acme Investment Company the sum of $5,000.00 and its ninety-day note for $1,600.00 (Transcript, pp. 19, 25 and 32) and that this sum had in truth and in fact been deposited by the Sun Drug Company with the Acme Investment Company as security for the faithful performance of the lease, notwithstanding that under the terms of the lease it was asserted that said money and note were given in consideration of the lease; the Trustee taking the position, therefore, that the Acme Investment Company, having within about five months of the entering into of the lease notified the tenant to quit, was holding $5,000.00 of the tenant's money and that any claim for rent asserted by the

Acme Investment Company against the estate should be offset as against the monies thus held as security by the Acme Investment Company.

Upon the hearing of the claim and petition of Acme Investment Company and the objections of the the Trustee thereto, no evidence was taken, but counsel for the Trustee and counsel for the Acme Investment Company agreed as to the facts. The Referee states these facts in his decision and order as follows: (Transcript, pp. 18-19.)

> "The agreed facts in the dispute are that a few months before this failure a real estate agent procured the Sun Drug Company as a tenant for the Acme Investment Company at a total rental of $141,000 over a ten-year period which would be at the rate of $1,180 per month. Before the lease was signed it was agreed that said total rent of $141,000 should be so distributed as that $6,600 should be deducted or paid at the signing of the lease and that the balance of $134,400 should be paid during the term at the rate of $1,045 for the first five years and $1,195 for the last five years, thus completing the total contract of $141,000. It was conceded at the hearing that the purpose of the parties in thus disposing of the consideration was to *secure to the lessor the faithful performance of the lease* by the Sun Drug Company.
>
> "The lease itself, after the formal parts, covers the subject in this language:
>
> > " 'Now therefore, in consideration of the sum of Five Thousand ($5,000.00) Dollars in cash and the promissory note of the Lessee in

favor of the Lessor due April 15th, 1923, in the sum of Sixteen Hundred ($1,600.00) Dollars, the receipt of said cash and note being hereby acknowledged by the Lessor, and in further consideration of the rentals herein reserved, and of the covenants herein contained on the part of the Lessee, to be paid and to be kept and faithfully performed by it, said Lessor does hereby lease, demise,' etc.

"Prior to the filing of the petition in bankruptcy, as shown by the exhibits in the case, the Acme Investment Company cancelled this lease and notified the tenant to quit."

QUESTION INVOLVED

The question, therefore, is: Is the landlord, the Acme Investment Company, entitled to retain the $5,000.00 cash paid under the aforesaid situation, plus the monthly rents that were received, and also to recover against the Trustee the rental for the period of the Trustee's occupancy without the right of the Trustee to offset the amount due by the estate to the Acme Investment Company for rent during the period of administration against the $5,000.00 received by the Acme Investment Company at the time of the entering into of the lease?

The Referee in Bankruptcy held that, notwithstanding the lease stated in terms that the $5,000.00 paid at the time of the entering into of the lease together with the giving by the Lessee of the ninety-day

note for $1,600.00 and an agreement to pay monthly rentals were the consideration for the lease, yet the facts and circumstancs and admitted intentions of the parties were that the *$5,000.00 cash payment and the note were paid and given as security for the due performance of the lease* and that under the law, as interpreted by the Oregon decisions, where money in fact is deposited as security "for the faithful performance of the lease even though the language of the lease itself tends to indicate the contrary * * * the retention of the money secured under such circumstances will be regarded as a penalty or forfeiture and upon termination of the lease by the landlord he must pay back the money deposited." (Transcript, pp. 20-21.) It was therefore ordered by the Referee that the petition of the Acme Investment Company to require the payment by the Trustee of rental for the use of the premises by the Trustee be disallowed. (Transcript, p. 23.)

Upon review of this decision by the District Court of the United States for the District of Oregon the District Court held that the language of the lease was plain and unambiguous and that parole evidence was not admissible to alter or vary the terms of a written contract and that therefore the plain provisions thereof should be enforced as written. (Transcript, pp. 32-35.) The order of the Referee was, therefore, reversed.

ERROR ALLEGED

The error alleged is the failure of the District Court, in the interpretation of the lease, to look to the admitted intentions of the parties in depositing the $5,000.00 in question and in determining that the situation presented an issue as to whether or not the plain terms of a written contract could be varied by parole evidence.

ARGUMENT

From what has been stated it will be seen that the questions to be discussed here are not complex, and we shall endeavor to analyze them without undue prolixity.

It should be premised that:

I

In the interpretation of a contract by a Court of Bankruptcy its construction and validity must be determined by the laws of the state.

See:

In re Hartdagen, 198 Fed. 486, 548;

Scandinavian-American Bank v. Sabin, (C. C. A. 9th Cir.) 227 Fed. 579, 582;

Humphrey v. Tatman, 198 U. S. 91; 25 Sup. Ct. 576, 569; 9 L. Ed. 956; 14 A. B. R. 74;

York Mfg. Co. v. Cassel, 201 U. S. 344, 26 Sup. Ct. 481, 484; 50 L. Ed. 782, 15 A. B. R. 633;

Thompson v. Fairbanks, 196 U. S. 516; 25 Sup. Ct. 306, 308; 49 L. Ed. 577, 13 A. B. R. 437.

Consequently in the interpretation of the lease in question we must look to the laws as promulgated by the courts of last resort in Oregon and we are not concerned with the law as promulgated in other states, since the lease was made in Oregon, upon Oregon property, and was to be carried out and performed in Oregon.

Now the terms of the lease provide that,

"* * * in consideration of the sum of Five Thousand ($5,000.00) Dollars in cash and the promissory note of the Lessee in favor of Lessor due April 15th, 1923, in the sum of Sixteen Hundred ($1600.00) Dollars, the receipt of said cash and note being hereby acknowledged by the Lessor, and in further consideration of the rentals herein reserved, and of the covenants herein contained on the part of the Lessee to be paid and to be kept and faithfully performed by it, said Lessor does hereby demise and let unto said Lessee that certain store, * * * *." (Transcript, p. 25.)

It will be seen that the consideration for the lease was:

1. $5,000.00 in cash.

2. Note of $1600.00.

3. The stated rentals aggregating $134,400 payable in monthly installments as set forth therein.

4. The performance by the Lessee of the covenants therein contained.

At the time of the entering into of the lease it was agreed that the total rentals upon the premises for the ten-year term should be $141,000 and instead of distributing these rentals equally over each month of the ten years it was determined to distribute the same as follows: $6,600.00 at the time of the entering into of the lease ($5,000.00 being in cash and $1,600.00 in a ninety-day note) and the balance in installments of $1,045.00 for each month of the first five years and $1,095.00 for each month of the last five years, bringing the total to the agreed rental of $141,000.00 for the entire term. As stated by the Referee,

> *"It was conceded at the hearing that the purpose of the parties in thus disposing of the consideration was to secure to the Lessor the faithful performnace of the lease by the Sun Drug Company."*

That is to say, that the purpose of requiring the payment of the $6,600.00, $5,000.00 of which was paid in cash and $1,600.00 by negotiable note, was *security,* and upon the payment of the same, or agreement to pay the same, this sum was deducted from the rental agreed to be paid, to-wit: $141,000.00, leaving to be distributed in monthly payments during the term a balance of $134,400.00. From each month's rent as originally agreed there was deducted a proportionate amount of the $6,600.00 which latter sum, as

heretofore stated, was required to be paid in a lump sum prior to or at the time of the entering into of the lease as a security or assurance that the terms of the lease would be performed.

The Oregon courts have stated time and again the doctrine (as have also the courts of many other states) that

II

When money is deposited or paid to a Lessor as security for the performance of a lease and the lease is terminated by the Lessor, the Lessee or its or his representative is entitled to recover the amount of money paid as such security less the damages resulting and this notwithstanding that the language of the lease specifically states that such deposit or money paid shall be considered as liquidated damages and shall be retained by the Lessor.

See:

Moumal v. Parkhurst, 89 Ore. 248, 251-255;

Alvord v. Banfield, 85 Ore. 49;

Yuen Suey v. Fleshman, 65 Ore. 606.

The Oregon Supreme Court in the case of Moumal v. Parkhurst, supra, said:

> "For the purposes of this opinion all of the material allegations of the complaint are deemed to be true and the question presented is whether,

under the terms and provisions of the lease, the $10,000.00 was a deposit or an actual payment, and whether the money is to be treated as a penalty or as liquidated damages. There is no provision in the lease for a reletting of the premises by the landlord on account of the tenant for nonpayment of rent or the breach of any covenant. It is alleged that the defendants evicted plaintiff from the premises and thereby terminated the lease and plaintiff's tenancy; that defendants have been in possession ever since and have collected the rents. * * * Assuming that the lease was terminated, it is the defendants' contention that the $10,000.00 was an actual payment by plaintiff to defendants at the time the lease was executed and that through a failure of the plaintiff to pay rental as provided for in the lease they are now entitled to keep and retain the money as a penalty under the terms and provisions of the lease. * * *

"Under the record we construe the lease to mean that the $10,000.00 was a deposit with the lessors; that the title to the money remained in the lessees, subject to the terms and conditions of the lease, and that it was not an actual payment to the lessors at the time of the execution of the lease. The question is then presented as to whether the $10,000.00 is a penalty or liquidated damages. The case of Cummingham v. Stockton, 81 Kan. 780 (106 Pac. 1057, 19 Ann. Cas. 212), is almost identical with the case at bar and it was there held:

" 'That the deposit could not, under the circumstances, be regarded as liquidated damages, and that when the landlord elected to dispossess

the tenant he terminated the lease and ended the obligation of the tenant under it for the remainder of the term and was not entitled to retain the deposit, except so much of it as was necessary to pay the rentals which had accrued when possession was taken.'

"In Caesar v. Rubinson, 174 N. Y. 492 (67 N. E. 58) it was held that:

" 'The landlord, having asserted his right to reenter for failure of the tenant to pay a monthly rent of $45.", * * * thereby waived the claim to the deposit except so far as it was necessary to apply it in payment of rent then due or accrued.'

"The New York case is cited and approved by this court in a well-considered opinion by Mr. Justice Ramsey in the case of Yuen Suey v. Fleshman, 65 Ore. 606-613 (133 Pac. 803), in which the facts were very similar to those in the present case. It was there held that:

" 'The $5,000.00 deposited by the respondent should be regarded as a penalty to secure the performance of the conditions of the lease on the part of the lessee, and *not* as liquidated damages.'

"In that case the appellant elected to terminate the lease for nonpayment of rent and ejected the respondent by an action at law. It was said that:

" 'This effectually terminated the tenancy and exonerated the lessee from all liability for rent not due at the time of such ouster.'

"The same rule is laid down in the case of Northern Brewery Co. v. Princess Hotel, 78 Ore. 453 (153 Pac. 37) and the rule is sustained by the weight of authority.

"We hold that under the terms and provisions

of the lease the $10,000.00 was a deposit and was not an actual payment; that it should be treated as a penalty and not as liquidated damages."

And in the case of Alvord v. Banfield, supra, it is said:

"This brings us to the question: Was the $2,500.00 deposited as security for the performance of the covenants or was it under the stipulation of the demise liquidated damages? As a general rule the intention of the contracting parties is an important, if not a conclusive, element in determining whether a sum stipulated to be paid in case of the breach of a contract is to be regarded as liquidated damages or a penalty. Modern authorities attach greater importance to the meaning and intention of the parties than to the language of the clause designating the sum as a penalty or as liquidated damages: Salem v. Anson, 40 Ore. 339 (67 Pac. 190, 91 Am. St. Rep. 485, 56 L. R. A. 169); Wilhelm v. Eaves, 21 Ore. 194 (27 Pac. 1053, 14 L. R. A. 297). The tendency and preference of the law is to regard the stipulation or covenant as of the nature of a penalty rather than as liquidated damages, for the reason that then it may be apportioned to the actual loss sustained and compensation for such loss is the full measure of right and justice. Where the circumstances and the nature of the stipulation are such that the actual damages are not ascertainable with any degree of certainty the rule stated does not apply. If there is an agreement for a fixed, unvarying sum, without regard to the date of the breach, when in the very nature of things the date

of the breach would be all-important in determining the element of actual damages, the stipulation must be held to be one for a penalty: 8 R. C. L., Sec. 114, p. 564; note, Ann. Cas. 1912C, p. 1025. In Section 115 of 8 R. C. L., p. 567, the author states:

"'In other words, the damages stipulated for must be such as to amount to compensation only, and if the principle of compensation has been lost sight of the sum named will be treated as a penalty.'"

Now it may be stated here that it is not claimed that the terms of the leases in the cases of Alvord v. Banfield and of Moumal v. Parkhurst are the same as in the case at bar. They are not. But the principles involved are the same. That is to say, the doctrine is promulgated that, notwithstanding the terms of a lease are unambiguous and clearly provide that certain monies paid at the time of the entering into of the lease or then deposited are to be considered as liquidated damages or are to be considered as the full measure of damages or are to be considered as payment or as anything other than a penalty or security when in fact and in truth the intentions of the partie were that they were to be deposited or paid as security for the performance of the lease or to be a penalty for the failure to perform the same, the courts of equity will go behind the plain and unambiguous language of the contract for the purpose of determnining the intention of the parties and will seek out this intention and if it be found that the intention

was that the monies deposited or paid were deposited and paid as security for the performance of the lease or as penalty for failure to perform the same they will not enforce such provision but upon the termination of the lease by the landlord will require that the landlord pay back to the tenant the monies thus paid and deposited, less such damages as the landlord has suffered.

It will be seen, therefore, that the question in cases of this character is not one of varying the terms of a contract by parole evidence, as the District Court held. The fact is, the courts in cases of this kind concede that the language of the contract is clear but, notwithstanding the clearness of such language, parole evidence is heard for the purpose of discovering the intentions of the parties and when that intention is discovered equity not only varies the terms of the written contract but contradicts them. Time and time again have courts of equity held that where such intention is discovered irrespective of the language of the contract it will not enforce a penalty. So we maintain that the District Court lapsed into error in treating the subject involved as one involving the varying of the terms of a contract by parole evidence. The situation did not fall into such category.

However, even considering the case upon the theory of the decision of the District Court, we call the attention of the Court to the fact that

III

The language of the contract is not plain and unambiguous.

As heretofore stated, the lease provides that "in consideration of the sum of $5,000.000 in cash and the promissory note of the Lessee in favor of the Lessor due April 15, 1923, in the sum of $1,600.00, the receipt of said note and cash being hereby acknowledged by the Lessor and in further consideration of the rentals herein reserved and of the covenants herein contained on the part of the Lessee to be paid and to be kept and faithfully performed by it, said Lessor does hereby demise and let unto the said Lessee certain premises."

Now under these terms, what was the $5,000.00 in cash and the 1,600.00 in note given for? The terms of the lease say that in consideration of this cash and note and of the rentals reserved and of the faithful performance of the covenants the Lessor leases the premises in question. It does not, however, say that in consideration of the PAYMENT of the sum of $5,000.00 any more than it says in consideration of the SECURITY of $5,000.00. It does not even acknowledge the PAYMENT of the $5,000.00. But it specifically says the *"receipt"* of said cash and note "being hereby acknowledged". The question therefore very properly arises, was such sum deposited as "security" or as "payment"? Or, again, let us suppose that the first year's rentals had been paid—that

is to say, that the $5,000.00 in cash and the $1,600.00 note and the first year's rentals had been paid, and then the lease had been terminated by the Lessor within five months of the entering into thereof. Would the Lessor have a right to retain the rentals also? There would have been as much a consideration of the lease, had they been paid, as the $5,000.00 was. So we maintain and urge that the language of the lease, even taking the view of the District Court, is ambiguous and that by virtue of the doctrine promulgated by all courts under such circumstances parole evidence of the intention of the parties in the making of the lease was admissible in order to read the lease equitably and understandingly.

CONCLUSION

The parties in this case came together on the 15th day of February, 1923, with the definite understanding and intention that there was to be paid for the ten-year lease upon the premises the sum of $141,000.00, or approximately $1,175.00 per month. It was then agreed that there should be deposited or paid the sum of $5,000.00 in cash (and a ninety-day note of $1,600.00 given) *as security for the performance of the lease* and that the balance of the $141,000.00 should be distributed over the ten-year period —that is to say, during each month of the first five years the sum of $1,045.00 was to be paid and over each month of the second five years the sum of $1,095.00. Within approximately five months after

the payment of the $5,000.00 and the giving of the note for $1,600.00, the Lessor terminated the lease and notified the tenant to quit, claiming the right to retain the $5,000.00 plus the monthly rentals received as payment upon the lease. It is maintained that in view of the Oregon authorities quoted the real intention of the parties should be looked into and determined in interpreting this lease. And it is further maintained under these authorities that when such intention is inquired into, as it should be, it must follow that the $5,000.00 in question was deposited as security, and that upon the termination of the lease by the Lessor such security must be surrendered less such damages as the landlord has suffered.

It follows, therefore, that the Lessor, Acme Investment Company, has in its possession, belonging to the estate in bankruptcy, the sum of $5,000.00 and that said $5,000.00 should be subject to a set-off for the amount of the rent which the Trustee in Bankruptcy owes to it by reason of his occupancy of the premises during process of administration.

Respectfully submitted,

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